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SIPDIS

STATE FOR NEA/ELA, NEA/RA, AND EB/IDF
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SENSITIVE

E.O. 12958: N/A
TAGS: ECON EFIN ETRD EINV EG
SUBJECT: EGYPT'S FY2005/06 BUDGET: A MAKEOVER

Summary

¶1. (U) On June 7 the People's Assembly passed the budget for fiscal year (FY) 2005/2006. The new budget was drafted using the IMF Government Finance Statistics format, which allows for better use of fiscal tools and better assessment of the impact of fiscal policies on Egypt's economy. Total expenditures in FY 05/06 are projected to reach LE 188.7 billion and total revenues LE 130.2 billion, with a budget deficit of LE 58.5 billion or 9.3% of projected GDP. The GOE will need LE 56.4 billion, or 9% of GDP, in net borrowing to finance its deficit. The new budget format provides greater detail regarding revenues and expenses, including itemization of direct and indirect subsidies and expenditures previously categorized simply as "off-budget" expenses. The new format directly addresses local and international concerns regarding GOE fiscal transparency and the need to continue reforms to support economic growth. End summary

Parliament Approves GOE Budget

¶2. (U) On June 7 the Egyptian parliament approved the draft GOE budget for FY 2005/2006 (July 1, 2005 to June 30, 2006), which was unveiled by the Ministry of Finance (MOF) in late May. Projected government expenditures in the approved budget are LE 188.7 billion, up 17.9% from the current FY 2004/2005. Projected revenues are LE 130.2 billion, up 11% from the current FY. The projected deficit is LE 58.5 billion, or 9.3% of the projected FY 05/06 GDP of LE 629 billion, a slight decrease from the current FY deficit of 10.3% of GDP. Parliament increased by LE 860 million the funding allocated for education, health and utilities programs. President Mubarak is expected to sign the budget before July 1, after which it will be published in the Official Gazette. MOF also intends to publish the new budget on its website.

¶3. (U) In drafting the budget, MOF used, for the first time, the IMF Government Finance Statistics (GFS) 2001 system, an international standard system that significantly improves the budget's transparency. Parliament cleared the way for use of this new system in April 2005, when it amended the law regulating the GOE budget. The amendment allows for restructuring of the GOE budget to render it more consistent with IMF government accounting standards, a long-time concern of the international financial institutions and foreign donors, including the USG. MOF intends to reformat prior year budgets using the new system and post the revisions on its website. Until this is done, however, comparison of the FY05/06 budget with the current FY budget is only possible for a limited number of items.

¶4. (U) Unlike the previous budget format, the new GFS system specifies all expense and revenue items for all government agencies (with the exception of the military). Details are provided for all transactions affecting financial and non-financial assets, as well as expenses previously classified simply as "off-budget" items. Under the new system, indirect subsidies are also now clearly identifiable, as details must be provided for all government agency expenditures. Unlike the previous format, which broke the overall deficit into three distinct tiers and made it difficult to assess the GOE's financing needs, the new system produces an aggregate monetary deficit figure. This makes it easier to determine net government borrowing, project future expenses and revenues based on past performance, and quantify the impact of fiscal policies on government finances and the national economy.

Egypt's Statement of Government Operations

¶5. (U) Revenues: Total revenues in FY05/06 are projected to reach LE 130.2 billion, compared with LE 102.5 billion in FY04/05, an increase of 27%. Revenues include LE 81.6 billion from taxes, up 21.5% from the actual preliminary figures for FY04/05. (Note: This is based on the assumption that macroeconomic reforms will increase the growth rate to 5%, thereby increasing the tax base and offsetting the reduction in the marginal tax rate enacted in a new tax law, which will be reported septel. End note); LE 2.9 billion from foreign and domestic grants; and LE 45.7 billion from other revenues. The breakdown of the government's tax income includes LE 40.9 billion from general income tax, LE 25.5 billion from sales tax, LE 8.99 billion from customs and LE 6.3 billion from other tax sources, all constituting 62.7% of total revenues. Foreign and domestic grants, in the form of direct transfers to the budget, remain relatively stable, averaging LE 1.68 billion in both FY04/05 and FY05/06. Foreign and domestic grants for investment purposes dropped from LE 3.4 billion in FY04/5 to LE 2.9 billion in FY05/06. Other revenues include proceeds from several economic entities, including the Petroleum Authority, Suez Canal Authority and the Central Bank of Egypt. The Petroleum Authority is expected to transfer LE 12.6 billion to the general budget in FY05/06, compared with LE 6.5 billion in FY 04/05. The increase is largely due to re-categorizing of energy subsidies in the new budget format. Energy subsidies were previously identified as expenses of the Petroleum Authority, thereby reduced that entity's profits. The subsidies are now categorized as general GOE subsidies.

¶6. (U) Expenses: Total expenses for FY05/06 are LE 188.7 billion, up 17.9% from LE 160 billion in FY04/05. Expenses include LE 46.7 billion for compensation of public employees, a 14% from FY04/05. (Note: In what appears to be an election year move, the GOE has announced a 30% pay raise for public employees, substantially exceeding the normal 10% annual increase. End note.) LE 13.2 billion is allocated for Use of Goods and Services acquired by the GOE to provide public goods and services; LE 42.6 billion for interest payments, up 12.4% from FY04/05; LE 50.6 billion for subsidies, social benefits and grants; LE 18.2 billion for other expenses; and LE 17.4 billion for purchase of non-financial assets, also known as investments, which will decrease by 14% compared to FY04/05. The decrease in investment spending is likely due to the GOE's move to rely more on private sector investment to stimulate the economy. The subsidies, grants and social benefits item includes, for the first time, details on direct and indirect subsidies for food and energy. Direct subsidies totaled LE 15.6 billion in FY04/05 and will increase to LE 35.4 billion in FY05/06. Interest payments includes interest on domestic public debt of LE 38.4 billion; interest of LE 4.02 billion for external public debt; and LE 0.21 billion for expenses related to debt servicing.

¶7. (U) Operating Balance/Deficit: The comparison of revenues and expenses shows government revenues cover only 69% of operating expenses, or 30% of GDP, while revenues constitute only 20.7% of GDP. The deficit resulting from the shortage in revenues totals LE 58.5 billion, or 9.3% of the projected GDP for FY05/06. In the GFS system, the deficit is also known as the government's Operating Balance, which reflects the ongoing stability of the government's operations.

¶8. (U) Deficit Financing: The GFS system also requires calculation of the net acquisition of financial and non-financial assets (i.e., net borrowing), which is projected at LE 1.73 billion for FY05/06 budget. This amount is added to the general deficit, increasing the total to LE 60.3 billion or 9.6% of GDP. Total financing needs for FY05/06 are projected at LE 77.8 billion, mainly coming in the form of loans from the National Investment Bank (LE 14.3 billion), external loans (LE 0.91 billion), and Treasury bills and bonds (LE 61.7 billion). The GOE's net borrowing needs are then calculated by subtracting LE 3 billion in projected proceeds from privatization of public companies in FY 05/06 and LE 20.5 billion in public debt payments throughout the year from total financing needs, yielding a net borrowing need of LE 57.3 billion, or 9.1% of GDP.

Policy Objectives

¶9. (U) During his presentation of the budget to parliament, Minister of Finance Youssef Bhutros Ghali (YBG) stated that the FY 05/06 budget was not only more transparent, but also seriously addressed the economic problems facing Egypt, including the need to increase efficiency, decentralize fiscal policy, encourage investments, stabilize prices, create jobs and improve services while focusing on sectors with a comparative advantage. With this aim in mind, YBG said the budget sets out three specific policy objectives:

- Growth and achievement of GOE fiscal targets. The budget set a target growth rate of 6% for FY05/06, while reducing inflation to 6-7% by increasing investment and employment. Social programs remain intact to protect low-income earners and provide basic services, but spending priorities are designed to ensure, in the medium term, continued growth, price stability and rational management of the deficit and public debt.

- Assessment of the macroeconomic impact of fiscal policies. The new budget format allows the GOE to better identify revenue and expense items that directly affect economic activity and production of goods and services. Calculation of the net balance of financial and non-financial assets also allows for assessment of the effect of public spending on the deficit and ultimately the GOE's need for deficit financing from the banking sector, CBE or other sources.

- Modernization of fiscal policy tools. Restructuring of the GOE budget complements the recent customs and tax reforms, which were designed to improve domestic and external competitiveness.

Comment:

¶10. (SBU) In line with the GOE's recent agreement to publish IMF Article IV, the new budget brings the GOE one step closer to meeting international standards for fiscal transparency. Local analysts are generally positive about the new budget and the fact that the GFS format allows the GOE, and outside observers, to actually assess the outcome of the GOE's fiscal policies. This will certainly facilitate the ongoing World Bank public expenditure review by helping to identify areas in which further reform is needed. Indeed, the budget appears designed to consolidate the reforms already made under the Nazif administration and set the stage for continued reform, particularly in the area of subsidies. One local private sector economist noted that by clearly identifying subsidies, the GOE will be better able to make the case to the Egyptian public that spending on subsidies is excessive and in need of reform.

¶11. (SBU) Despite the increase in transparency, however, the new budget has its limitations. Specifically, it does not disclose military spending, which accounts for a large percentage of annual expenses. In not disclosing the details of military spending, another set of subsidies, namely those to military personnel and their families, is not specified. Given the perhaps overly optimistic projection of revenues for FY 05/06, reform of large expenditures, such as subsidies, is badly needed to control an already large deficit. Such reforms, however, will likely have to wait until after this year's elections. End comment.

Draft Budget As Presented to Parliament

¶12. (U)

(LE Billion)	Budget	Budget	Projected % Change
Fiscal Years	2004/2005	2005/2006	
Expenses,	160.00	188.67	17.92
Including:			
Wages and Compensation	41.00	46.70	11.80
Use of Goods and Services	9.94	13.24	33.20
Interest	38.43	42.61	10.88
Subsidies, Social Benefits And Grants	29.32	50.55	72.41
Other Expenses	21.05	18.19	(13.40)
Purchase of Non-Financial Assets	20.26	17.40	(14.15)
Revenues,	102.46	130.15	27.03
Including:			
Taxes	71.21	81.61	14.60
Grants	2.90	2.86	(1.38)
Other Revenues	28.35	45.68	61.13
Deficit (Operating Balance)	57.54	58.52	
GDP	558.00	629.00	
Deficit/GDP (%)	10.3	9.3	
Net Borrowing:			
Net Acquisition of Assets		1.73	

Total Deficit	60.25
Payment of Debt Installments	20.55

	80.80
Privatization Proceeds	3.00
Financing Required	77.80
Covered by*:	
Loans from National Investment Bank	14.33
External Debts to Finance Investments	0.91
Borrowing using T- Bills and Bonds	61.71

* Available information did not indicate how the additional LE 850 million will be financed.

New Financing Needs	77.80
Payment of Debt Installments	20.55
Net Borrowing	57.25
Net Borrowing/GDP(%)	9.11

Administrative Classifications

¶13. (U)

	FY04/05	Projected FY05/06			
Activities		Admin.	Municipal	Services	Total*
Public Services (LE Billion)	55.75	54.09	7.97	0.63	62.69
Defense And Nat'l Security	14.11	15.63	--	0.007	15.64
Public Order And Public Security Affairs	7.52	7.90	--	0.41	8.31
Economic Affairs	10.91	3.86	1.99	3.43	9.29
Environment Protection	0.71	0.70	--	0.26	0.96
Housing, Utilities/ Communities	3.76	0.90	0.25	2.39	3.55
Health Affairs	7.64	3.56	3.04	1.61	8.21
Youth, Culture And Religious Affairs	5.45	4.95	0.45	0.92	6.32
Education	22.69	4.01	14.46	6.22	24.69
Social Protection	31.56	47.60	0.52	0.06	48.18
Total	160.10	143.19	28.68	15.95	188.67

* Available information did not indicate how the additional LE 850 million will be financed.
GRAY